IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. [redacted] 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals (R. 87a-94a), Judge Moore dissenting (R. 94a-104a), is reported at 335 F. 2d 15 (2d Cir. 1964) and is reprinted in Appendix A, *infra,* pp. 1a-19a.* The memorandum opinion of the Tax Court (R. 3a-22a) is not officially reported, but is unofficially reported at 21 CCH T. C. Memo. 1533 (1962) and at 1962 P-H T. C. Memo. ¶ 62,290.

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*References to "R." are to the certified transcript of the record in this case, which includes the printed Appendix to Petitioner's Brief in the Court of Appeals. For the convenience of the Court, we have filed nine additional copies of that Appendix, the pages of which are numbered the same as the corresponding portion of the certified transcript.

JURISDICTION

The judgment of the Court of Appeals (Appendix A, *infra,* p. 20a) was entered on July 15, 1964. (R. 105a-106a.) An order of the Court of Appeals denying a timely petition for rehearing and granting a timely motion to stay issuance of its mandate (Appendix A, *infra,* p. 21a) was entered on August 20, 1964. (R. 117a.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTION PRESENTED

Whether, as a matter of law, the sale of depreciable property for an amount in excess of its depreciated cost at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during that year.

STATUTE AND REGULATIONS INVOLVED

The statute involved is section 167(a) of the Internal Revenue Code of 1954, 26 U. S. C. § 167(a), which provides:

> SEC. 167 DEPRECIATION.
>
> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

The regulations involved are sections 1.167(a)-1, 1.167(a)-9 and 1.167(a)-10 of the Income Tax Regula-

tions (26 C. F. R. §§ 1.167(a)-1, 1.167(a)-9 and 1.167(a)-10), pertinent portions of which are reprinted in Appendix B, *infra,* pp. 1b-5b.

STATEMENT OF THE CASE

The material facts in this case are undisputed and are as follows:

Petitioner, a Delaware corporation organized in 1946, owned and operated ships for charter to others for the carriage of cargoes in foreign commerce. (R. 4a.) On December 21, 1955, petitioner purchased the *S.S. Joseph Feuer* (the *"Feuer"*), a Liberty-type dry cargo ship, for $469,000. (R. 4a.) Petitioner operated the *Feuer* under the American flag as a tramp ship for the carriage of various dry cargoes from the United States to Asian and African ports. (R. 9a.)

The *Feuer* had been built in 1943 for emergency use during World War II. (R. 4a.) In postwar commerce Liberty ships carried low-paying bulk commodities, principally grain and coal. (R. 10a.) Being slow and of low cargo capacity and facing mounting competition from more modern ships, Liberty ships were rapidly becoming obsolete. (R. 9a-10a, 13a.)

Before purchasing the *Feuer,* petitioner applied for and received a letter ruling from respondent's office, dated December 8, 1955, with respect to its depreciation. (R. 4a.) The ruling stated that the Internal Revenue Service would accept a useful economic life of three years from the date of acquisition and a salvage value of $5 per dead weight ton ($54,000) for the *Feuer.* (R. 4a-5a.) The ruling further stated that the *Feuer's* cost of $469,000, less its $54,000 salvage value, should be spread ratably over its three-year useful economic life. (R. 5a.)

Petitioner claimed deductions for depreciation of the *Feuer* for the 10-day period of its use during 1955 and the entire year 1956 as provided by the ruling. (R. 5a-6a.) The Internal Revenue Service audited petitioner's income tax returns for those two years and accepted the depreciation deductions without adjustment. (R. 6a.) The depreciated cost of the *Feuer* as of the beginning of 1957 was $326,627.73. (R. 6a.)

The economic and market conditions resulting from the blockage of the Suez Canal in 1956-1957 temporarily inflated charter rates and ship prices. (R. 6a-7a.) As a result, the *Feuer* appreciated in value. (R. 7a.) In June of 1957 Isbrandtsen Company, Inc. ("Isbrandtsen"), one of petitioner's competitors, offered an excellent price for the *Feuer,* which petitioner accepted. (R. 7a.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen for $700,000 (which price was subsequently reduced to $695,000 in connection with a change in financing). (R. 7a-8a.) The contract called for delivery of the *Feuer* to Isbrandtsen in December of 1957, and petitioner made delivery on December 23, 1957. (R. 7a-8a.)

Petitioner had not followed a practice of using ships for a short time and then reselling them while still in good operating condition. (R. 8a, 17a.) Petitioner had not put the *Feuer* up for sale, but decided to sell it because Isbrandtsen had offered an excellent price. (R. 7a.) The contract of sale was entered into halfway through the three-year useful economic life established for the *Feuer* by the ruling letter (R. 7a), and when the *Feuer* was delivered to the purchaser one-third of that useful life remained. (R. 8a.)

Conditions at the end of 1957, when the *Feuer* was delivered to the purchaser, tended to confirm the correctness of the forecasts of useful economic life and salvage value made in the ruling letter. Charter rates had fallen

sharply (R. 10a-11a), competition for dry bulk cargoes was increasing (R. 10a, 12a), Liberty ships were finding it harder to secure cargoes (R. 12a-13a), and prices of such ships were falling (R. 13a), all of which confirmed the *Feuer's* obsolescence. Scrap steel prices were also falling, and the scrap value of a Liberty ship was between $53,000 and $60,000 (R. 13a), almost exactly as established by the ruling letter.

In its 1957 tax return, petitioner reported gross profit of $289,340 from the operation of the *Feuer* up to the date of sale. (R. 8a-9a.) Petitioner also deducted $135,367.24 for depreciation of the *Feuer* during the period of such operation, under the formula authorized by the ruling letter and used and approved for prior years. (R. 5a, 8a.) Respondent has never questioned the originally established three-year useful economic life for the *Feuer* (R. 17a) nor changed the ruling letter as to such useful life or as to salvage value. (R. 6a.) Nevertheless, respondent completely disallowed the 1957 depreciation deduction (R. 8a), and defended such disallowance on the sole ground that, as a matter of law, the profitable sale of the *Feuer* barred any depreciation deduction for the year of sale. (R. 14a.)

The Tax Court sustained respondent's disallowance. (R. 2a-22a.) The Court of Appeals affirmed (R. 87a-94a), Judge Moore dissenting (R. 94a-104a).

REASONS FOR GRANTING THE WRIT

I. The Question Is One of General Importance Which Is Being Widely Litigated, and Will Continue To Be So Litigated Until It Is Authoritatively Settled.

The eleven million business taxpayers in the United States[1] own an immense quantity of equipment, machinery,

[1]Statistics of Income—1961-62, U. S. Business Tax Returns, United States Government Printing Office (1964), Table A.

buildings and other depreciable property. Their depreciation deductions exceed $32 billion annually, and the depreciable assets of corporate taxpayers alone exceed $450 billion.[2] Every day a portion of this huge volume of depreciable property is sold, frequently at a profit in this postwar era of rising price levels. The decision below threatens a vast number of taxpayers with denial of any depreciation deduction for the year of profitable sale of their depreciable assets.

From the inception of the income tax law until very recently—a period of almost 50 years—everyone, including respondent, agreed that depreciation was allowable for the year of profitable sale.[3] Respondent has recently attempted to overthrow this well-established rule,[4] and large numbers of taxpayers have resisted. A large volume of litigation has resulted, which will continue to swell until the right to depreciation in the year of sale—currently the most widely important disputed issue of income tax law—is authoritatively settled.

The Tax Court and five United States District Courts have already considered respondent's change of position in cases involving depreciation of a variety of assets—rental housing projects, office buildings, shopping centers, automobiles, manufacturing plants, and machinery and equipment—as well as petitioner's Liberty ship. Five of these six trial courts have expressly rejected that change of position and adhered to the traditional view that depreciation is allowable in the year of profitable sale of the asset.

Most dramatically, the Tax Court has just decided, after a close scrutiny of respondent's new position, that it is "incorrect" and fails "to comply with the underlying

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[2]*Id.*, Tables A and 27.
[3]See pp. 9-12, *infra*.
[4]See pp. 12-13, *infra*.

intent of section 167 and the specific provisions of his own regulations thereunder." *Macabe Company, Inc.*, 42 T. C. —, No. 87 (September 29, 1964).[5] Earlier, in two unreviewed decisions by single judges, the Tax Court had accepted respondent's change of position. *Randolph D. Rouse*, 39 T. C. 70 (1962), and the instant case. However, in *Macabe*, which was reviewed by the entire Court, the Tax Court said it "decline[d] to follow" its decision in *Rouse* and disagreed with "the rationale relied upon by a majority of the panel" of the Second Circuit in the instant case. 42 T. C. at p. —, CCH Tax Ct. Rep., Dec. 26,982, at pp. 3025, 3029; ¶ 42.87 P-H TC, at pp. 806-42, 810-42.[6]

Four of the five District Courts which have considered respondent's new position have also rejected it. *Motorlease Corporation* v. *United States*, 215 F. Supp. 356 (D. Conn. 1963), *rev'd*, 334 F. 2d 617 (2d Cir. 1964),[7] cert.

[5]The current Tax Court position is further refined in *Smith Leasing Co.*, 43 T. C.—, No. 5 (October 20, 1964), and *Palmaneda Adams*, T. C. Memo. 1964-286, CCH T. C. Memo. 1743, 1964 P-H T. C. Memo. ¶ — (October 30, 1964).

[6]The *Macabe* opinion, though rejecting the rationale of the majority below, suggested that the Tax Court decision in the instant case could be justified on the ground that petitioner failed to prove its depreciation allowance had not been excessive. However, in sustaining respondent in the instant case, the Tax Court relied wholly on the principle announced in the *Rouse* case "that a depreciation deduction is not allowable for the year in which an asset is sold where the sales price of such asset is in excess of the asset's undepreciated cost as of the beginning of the year of sale," and found "the *Rouse* case . . . dispositive of the question presented." (R. 21a-22a.) The Tax Court found below that petitioner's estimate of useful life was "not questioned," and that petitioner's "extensive evidence in support of its original estimate of salvage value" established a scrap value for Liberty ships at the end of 1957 of "between $53,000 and $60,000"—figures in line with the original $54,000 estimate of salvage value and far below the *Feuer's* adjusted basis at the beginning of the year of sale. (R. 17a.)

[7]This two-to-one reversal of the District Court was dissented to by Judge Waterman on the grounds stated by Judge Moore in his dissent in the instant case.

applied for; *Kimball Gas Products Co.* v. *United States,* 63-2 U. S. T. C. ¶ 9507, 12 A. F. T. R. 2d 5105 (W. D. Tex. 1962), on appeal to 5th Cir.; *S & A Co.* v. *United States,* 218 F. Supp. 677 (D. Minn. 1963), on appeal to 8th Cir.; *Wyoming Builders, Inc.* v. *United States,* 227 F. Supp. 534 (D. Wyo. 1964), on appeal to 10th Cir.; *contra, Killebrew* v. *United States,* 64-2 U. S. T. C. ¶9728, 14 A. F. T. R. 2d 5565 (E. D. Tenn. 1964).

Appeals by the Government from the adverse District Court decisions in the *Kimball Gas Products Co., S & A Co.* and *Wyoming Builders, Inc.* cases are pending in the Fifth, Eighth and Tenth Circuits, respectively,[8] and we understand that respondent intends to petition the Ninth Circuit for review of the Tax Court's adverse decision in *Macabe Company, Inc.* Similar cases are pending in several other District Courts, and many additional cases are being held in reserve administratively until the issue is definitely resolved.

The overwhelming weight of contemporaneous adjudication thus rejects respondent's recent change of position, but the majority opinion below gives it sufficient support to obstruct disposition of the numerous pending cases. A prompt decision by this Court is essential to avoid a prolonged period of uncertainty and dispute, both for the large number of taxpayers with pending tax controversies for prior years, and for taxpayers who currently must prepare income tax returns for the year of sale of depreciable property.[9] Unneces-

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[8]The *Kimball Gas Products, Inc.* case was argued before the Fifth Circuit on November 14, 1963 and the *S & A Co.* case before the Eighth Circuit on May 14, 1964.

[9]The issue presented here is of continuing importance for current and future taxable years except where the increased gain attributable to depreciation for the year of sale is taxable as ordinary income. Section 1245, added to the Internal Revenue Code in 1962, provides prospectively for such ordinary income treatment in the case of personal property only. With respect to real estate, the question

sary delay in the disposition of this issue will result in the expiration of statutes of limitations applicable to a host of taxpayers who lack the financial resources to resist respondent's position.

II. The Decision Below Conflicts in Principle and Result with Decisions of This Court and Discards Long-Established Construction and Practice.

The decision of the Court of Appeals contradicted a vast body of precedent, including decisions of this Court, lower court decisions, administrative rulings and practice, and indicia of Congressional intent.

A. The Long-Standing Precedents

In *Eldorado Coal & Mining Co.* v. *Mager,* 255 U. S. 522 (1921), this Court sustained an assessment arrived at by "subtracting depreciation and depletion to the date of sale" of a coal mine in May of 1917 and computing profit on the sale accordingly. Again, in *United States* v. *Ludey,* 274 U. S. 295 (1927), this Court upheld a determination of gain on the sale of properties arrived at by deducting depreciation and depletion to the date of their sale in February of 1917 and adjusting the bases of the properties accordingly. In each of these cases respondent allowed depreciation on property in the year of its profitable sale and, with approval of this Court, adjusted the basis of the property for such depreciation in determining the profit on the sale.[10]

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whether depreciation should be allowed for the year of sale remains of prime importance. Section 1250, added to the Internal Revenue Code in 1964, generally provides that only the excess of accelerated depreciation over straight line depreciation shall be treated as ordinary income on the sale of real estate, and even such excess is freed from such treatment under a scale related to the period the property was held.

[10]This is also the business accounting practice. Paton, Accountants Handbook 685 (note 45), 742, 773, 777 (3d Ed. 1944); 1 Dewing, The Financial Policy of Corporations 581, note 39 mmm (5th Ed.

Respondent's long-established practice of allowing depreciation on properties in the year of their profitable sale is reflected in many other court decisions. *Kittredge* v. *Commisssioner,* 88 F. 2d 632 (2d Cir. 1937); *Beckridge Corporation* v. *United States,* 129 F. 2d 318 (2d Cir. 1942); *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (3d Cir. 1938); *Hall* v. *United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U. S. 664 (1942); *Grosvenor Atterbury,* 1 B. T. A. 169 (1924); *Even Realty Co.,* 1 B. T. A. 355 (1925); *W. W. Carter Co.,* 1 B. T. A. 849 (1925); *Star Sporting Goods Co.,* 1 B. T. A. 1266 (1925); *Keighley Mfg. Co.,* 2 B. T. A. 10 (1925); *Marchetti Roma Cafe Co.,* 2 B. T. A. 529 (1925); *Walter Frank,* 2 B. T. A. 905 (1925); *Cotton Concentration Co.,* 4 B. T. A. 121 (1926); *Capital City Investment Co.,* 4 B. T. A. 933 (1926); *Island Line Shipping Co.,* 4 B. T. A. 1055 (1926); *Seton Falls Realty Co.,* 6 B. T. A. 883 (1927); *Parkersburg & Marietta Sand Co.,* 11 B. T. A. 87 (1928); *Louis Kalb,* 15 B T. A. 865 (1929); *Franklin Lumber & Power Co.,* 18 B. T. A. 1207 (1930), *rev'd on other grounds,* 50 F. 2d 1059 (4th Cir. 1931).

In 1930, at the insistence of respondent, the Board of Tax Appeals expressly held that depreciation had to be taken by the taxpayer in the year of sale of the depreciable property at a profit. *Herbert Simons,* 19 B. T. A. 711 (1930).[11] The Tax Court again so held in 1947, this time

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1953). This Court has recognized that the income tax allowance is for depreciation as "charged in practical bookkeeping." *Stratton's Independence, Ltd.* v. *Howbert,* 231 U. S. 399, 423 (1913); *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 524 (1917); *cf. Real Estate Title Co.* v. *United States,* 309 U. S. 13, 16 (1940).

[11]Since the taxpayer in the *Simons* case had deductions in excess of his ordinary income but insufficient to wipe out the capital gain on the sale, he would have paid a lower tax by not taking the depreciation.

at the urging of the taxpayer, in the only case up to that time in which respondent had attempted to disallow depreciation for the year of sale. *Wier Long Leaf Lumber Co.*, 9 T. C. 990, 999 (1947), *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949). Respondent promptly acquiesced in this adverse decision. 1948-1 C. B. 3.[12]

The Third Circuit has held, *Rieck* v. *Heiner*, 25 F. 2d 453, 454 (3d Cir.), *cert. denied*, 277 U. S. 608 (1928), that "in computing the gain from a sale of property a deduction of depreciation during the period of operation shall be made." Similarly, the Eighth Circuit has held, *Forrester Box Co.* v. *Commissioner*, 123 F. 2d 225, 229 (8th Cir. 1941), that a taxpaper who sold machinery and equipment on July 1, 1929 should have "an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929."

Respondent's rulings reflect the same approach toward allowance of depreciation. In 1922 respondent approved depreciation of property to $40,000 in the year of its sale for $47,000. I. T. 1494, I-2 C. B. 19, 20-21. He again approved depreciation in the year of profitable sale in rulings issued in 1924 (A. R. R. 6930, III-1 C. B. 45) and 1927 (G. C. M. 1597, VI-1 C. B. 71), and by publication in 1928 of the decision of the Third Circuit in *Rieck* v. *Heiner*, *supra* (VII-1 C. B. 200).

In the light of the above decisions and rulings and the administrative practice reflected in them, Congress repeatedly reenacted the depreciation statute without relevant

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[12] The purpose of acquiescence is to furnish taxpayers assurance that they can rely upon the disposition of the issue "without the danger of being forced to litigate the same question in their own cases." *Stockstrom* v. *Commissioner*, 190 F. 2d 283, 284 (D. C. Cir. 1951).

change.[13] Ample evidence of Congressional knowledge of the subject is found in its legislative actions. In 1942 Congress liberalized capital gains treatment for depreciable property.[14] In 1947-1948, in 1950, and in 1954 Congress failed to act on recommendations for recoupment of depreciation as ordinary income on sale of the property.[15] The Conference Report on the Revenue Act of 1950 contained an example specifically illustrating the allowance of $500 of depreciation in the year of sale of a facility at a $500 profit.[16] The Treasury Department has incorporated this example of such allowance in its income tax regulations since 1951.[17]

This body of court decisions, published rulings, administrative practice and acquiescence, statutory reenactment, Congressional statements and Treasury regulations created a sense of repose which respondent and the Second Circuit have only recently interrupted. On June 7, 1962, the day before the trial of this case in the Tax Court, respondent announced for the first time that he would no longer allow depreciation for the year of profitable sale of the depreciable asset.[18] This announcement brought into

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[13]Rev. Acts of 1921, 1924 and 1926, § 214(a)(8); Rev. Acts of 1928 and 1932, § 23(k); Rev. Acts of 1934, 1936 and 1938, § 23(l); Int. Rev. Code of 1939, § 23(l); Int. Rev. Code of 1954, § 167(a).

[14]Int. Rev. Code of 1939, § 117(j), added by Rev. Act of 1942, § 151(b); now Int. Rev. Code of 1954, § 1231.

[15]Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5, p. 3756; statement of Senator Milliken at 96 Cong. Rec. 14057 (1950); Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300, Part 3, p. 1324 (1954).

[16]H. Rep. No. 3124, 81st Cong., 2d Sess. 29 (1950).

[17]Reg. 118, § 39.117(g)-2, added by T. D. 5851, 1951-2 C. B. 63, 73. The example now appears in Reg. § 1.1238-1, issued in 1957 by T. D. 6253, 1957-2 C. B. 547, 562-563.

[18]Treasury Information Release 374, dated June 7, 1962. In 1962-26 I. R. B., dated June 25, 1962, respondent reissued this release as Rev. Rul. 62-92, 1962-1 C. B. 29, and withdrew his acquiescence in *Wier Long Leaf Lumber Co., supra,* 1962-1 C. B. 5.

the open what taxpayers had been gradually discovering upon audit, for respondent had privately instructed his agents a year or more earlier that they should commence disallowing such depreciation. Through this breach with precedent the large volume of pending cases was accumulated.

Against respondent's "prior longstanding and consistent administrative interpretation"— as repeatedly reflected and approved in decisions of this Court and many lower courts—his "more recent *ad hoc* contention as to how the statute should be construed cannot stand." *United States* v. *Leslie Salt Co.,* 350 U. S. 383, 396 (1956).

B. *Cohn* v. *United States*

In departing from the long-standing position which we have just described, the Second Circuit said only that its opinion was "strongly suggested" by the opinion of the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), and cited no other authority whatever. (R. 90a.) The Second Circuit took this radical step even though it recognized that *Cohn* had been "variously construed" and "could have been more explicit," and even though it thought respondent's construction of the *Cohn* decision was "perhaps logically inconsistent." (R. 90a-91a.) Unfortunately, the decision below so completely misunderstands the *Cohn* decision as to conflict with it in principle.

Respondent disclaimed in *Cohn*—and the Sixth Circuit certainly did not propound—the sweeping proposition of law asserted by the Second Circuit in its opinion below. In *Cohn* (a) the taxpayers had failed to set up any salvage value although it was clear that they should have done so, (b) both useful life and salvage value were in controversy for all years from the beginning of the use of the assets, and (c) the assets were sold "at or near the end of the useful life" determined by the District Court. 259 F. 2d at 373-375, 378. The Government, far from arguing any issue of

law, said on brief in *Cohn* that the District Court's finding that the salvage value of such assets equalled their sales price "was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an entirely different finding would result."[19] The Sixth Circuit, accepting this statement, said merely that "under the circumstances of this case, we are of the opinion that the District Judge was not in error" and that "his findings of fact with respect to salvage value are . . . not clearly erroneous." 259 F. 2d at 379.

As a narrow factual holding, the *Cohn* decision follows the great body of precedent which the Second Circuit has chosen to ignore.[20] In treating sales price as evidence of salvage value where the sale was at the end of useful life, it adheres to the traditional view that salvage value is the amount expected to be realized at the end of useful life and is not the amount realized at any other time.

The Tax Court and the District Courts which have rejected respondent's recent break with that body of precedent agree with us that *Cohn* does not aid him.[21] The *Cohn* opinion was briefed before this Court in *Massey Motors, Inc.* v. *United States,* 364 U. S. 92 (1960), and is well summarized in Mr. Justice Harlan's dissenting opinion (364 U. S. at 117-118); yet, as we note below, (a) this Court allowed depreciation on a number of automobiles in the year of their profitable sale and (b) Mr. Justice Harlan observed that not even respondent contended that depreciation must be keyed to the fortuitous sale of an asset in the middle of its useful life.[22]

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[19] Appellee's Brief, p. 32, in *Cohn* v. *United States, supra.* See Merritt, *Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation,* 20 Journal of Taxation 156 (1964).

[20] See pp. 9-12, *supra.*

[21] *Macabe Company, Inc., supra,* CCH Tax Ct. Rep., Dec. 26, 982, at pp. 3028-3029, ¶ 42.87 P-H TC, at pp. 42-809, 810-42; *Motorlease Corporation* v. *United States, supra,* 215 F. Supp. at 361-364; *S & A Co.* v. *United States, supra,* 218 F. Supp. at 683-684; *Wyoming Builders, Inc.* v. *United States, supra,* 227 F. Supp. at 538.

[22] See p. 15, *infra.*

Therefore, the opinion below stands alone—without support from *Cohn*—in contradicting the long-standing precedents allowing depreciation in the year of profitable sale. Because of the widespread importance of this question, the conflict created by the decision below on an issue otherwise long settled requires resolution by this Court.

III. Certiorari Should Be Granted To Prevent Further Misconstruction of this Court's Decision in *Massey Motors, Inc.* v. *United States*, 364 U. S. 92 (1960).

In *Massey Motors, Inc.* v. *United States, supra,* this Court, consistently with its actions in the *Eldorado Coal* and *Ludey* cases,[23] approved depreciation allowances for automobiles for the year of their resale which brought their depreciated cost below their resale price.[24] "Had the Supreme Court wished to declare the principle now urged by the Commissioner," observed Judge Moore in his dissent below, "it had every opportunity to do so merely by taking the actual sales price. However, it did not." (R. 99a.) Mr. Justice Harlan emphasized in his dissenting opinion in *Massey* that "even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held." 364 U. S. at 113.[25] This Court's decision in *Massey* is, therefore, inconsistent in result with the novel doctrine that depreciation

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[23] See p. 9, *supra*.

[24] The *Massey* decision, by reversing *Evans* v. *Commissioner*, 264 F. 2d 502 (9th Cir. 1959), approved depreciation allowances which reduced to $1,325 the depreciated cost of 140 automobiles which were sold in the same year for an average price of $1,380. 364 U. S. at 94-95; 264 F. 2d at 504-505.

[25] Emphasis in original.

should be disallowed for the year of profitable sale, and was decided with awareness that not even respondent subscribed to that doctrine. Nevertheless, respondent has based his change of position, as set forth in Rev. Rul. 62-92, *supra*, and his briefs in the cases in which that change has been in issue, on this Court's decision in *Massey*.[26]

This Court held in *Massey* that where the "experience" of the taxpayer establishes that assets "are not acquired with intent to be employed in the business for their full economic life," their "useful life" and "salvage value" must be related to such experience. 364 U. S. at 96-97, 107. Only thus can there be "a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." 364 U. S. at 104. This system of accounting for depreciation "has had the approval of this Court since *United States* v. *Ludey*, 274 U. S. 295, 301 (1927), when Mr. Justice Brandeis said, 'The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it.' " *Ibid.* Mr. Justice Brandeis added in *Ludey* that depreciation is the "measure of the cost of the part" that has been "sold" by being used, and approved the depreciation formula by which the "original cost" less "salvage value" is spread evenly over the plant's expected "useful life." 274 U. S. at 301.

Under the perceptive analysis in the *Ludey* and *Massey* cases, the depreciated cost of the *Feuer* as of January 1, 1957 must be allocated partly against its operating income for 1957 and partly against the sales price received in December of that year. Respondent and the Second Circuit, disregarding Mr. Justice Brandeis's allocation formula, have charged the cost remaining on January 1, 1957 wholly

[26] See, *e.g.*, Respondent's Brief in the Second Circuit in the instant case, pp. 9, 13-16, 18-19, 31, 39. See also the Tax Court's reliance on *Massey* in the instant case. (R. 14a-15a, 20a-21a, 22a.)

against the portion of the asset sold in December and nothing against the portion used up during the year. By rejecting the "meaningful allocation" of cost which this Court has approved, the Second Circuit has caused petitioner's income from operation of the *Feuer* to be heavily overtaxed.

Respondent is now applying his misconstruction of the *Massey* decision to countless taxpayers throughout the country to create a prolonged and inconclusive series of litigations. Only this Court can set the matter at rest.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 17, 1964.

APPENDIX A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

For the Second Circuit

No. 72—September Term, 1963.

(Argued January 16, 1964 Decided July 15, 1964.)

Docket No. 28165

Fribourg Navigation Company, Inc.,
Petitioner,

—v.—

Commissioner of Internal Revenue,
Respondent.

Before:

Swan, Moore and Smith,
Circuit Judges.

Petition to review a decision of the Tax Court of the United States, Marion J. Harron, *J.*, upholding disallowance of a depreciation deduction for taxable year in which an asset was sold for more than its depreciated cost. 39 T. C. Memo. 1962-290. Affirmed.

James B. Lewis, New York, N. Y. (Theodore Ness, Michael J. Nassau and Paul, Weiss, Rifkind, Wharton & Garrison, New York, N. Y., on the brief), *for petitioner.*

WILLIAM A. FRIEDLANDER, Attorney, Dept. of Justice, Washington, D. C. (Louis F. Oberdorfer, Asst. Atty. General, Lee A. Jackson and Harry Baum, Dept. of Justice, Washington, D. C., on the brief), *for respondent.*

SMITH, *Circuit Judge*:

The sole issue presented by this appeal is whether a taxpayer is entitled to a depreciation deduction for the year in which a depreciable asset is sold at more than its depreciated cost. The Tax Court sustained the Commissioner's disallowance of the deduction, and the taxpayer has appealed to this court. We agree with the Tax Court's determination and affirm the judgment.

The taxpayer, Fribourg Navigation Co., operated two cargo ships in foreign commerce. One of these was the *S.S. Feuer,* a Liberty ship purchased in December of 1955 for $469,000. Just prior to purchasing the *Feuer*, the taxpayer secured a letter ruling from the Engineering and Valuation Branch of the Internal Revenue Service advising that it would accept straight line depreciation of the ship over a useful economic life of three years, subject to change if warranted by subsequent experience. The letter ruling also advised that the Internal Revenue Service would accept a salvage value of $54,000 on the *Feuer*. This estimate of the *Feuer's* useful economic life and salvage value, concededly reasonable in December of 1955, was thrown out of kilter by a scarcity of ships resulting from the Suez Crisis of 1956-57, which sharply inflated the values of ships normally considered obsolete. In June of

1957 the taxpayer accepted an offer to sell the *Feuer* for $700,000, $231,000 more than it had paid for the ship a year and a half before. When the *Feuer* was delivered to its new owner on December 23, 1957, the contract terms were slightly modified, reducing the purchase price to $695,500.

Relying on the letter ruling, the taxpayer deducted the $54,000 estimated salvage value from the $469,000 cost and spread the $415,000 equally over a three year useful life—from December 21, 1955 to December 21, 1958. This resulted in a daily depreciation of about $378.65. On its income tax returns, the taxpayer claimed the following depreciation deductions for the *Feuer*:

Calendar Year	Period of Ownership	Depreciation
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	$277,739.51

On March 7, 1957, prior to the sale of the *Feuer*, the taxpayer adopted a plan of complete liquidation, which was carried out within 12 months. Since the liquidation came within the sanctuary of Section 337 of the Internal Revenue Code, the taxpayer incurred no tax liability on the capital gain from the sale of the *Feuer*. For information purposes only, the taxpayer reported a capital gain of $504,239.51 (the difference between the selling price and the adjusted basis after taking a depreciation allowance for 357½ days of 1957). The taxpayer reported a gross income (after cost of operations) of $391,811.31 in 1957.

This was reduced to $141,193.35 after deductions of $250,-617.96, including $135,367.24 for the depreciation of the *Feuer* in 1957.

The Commissioner disallowed the $135,367.24 deduction in full, taking the position that a taxpayer cannot depreciate an asset during the year its sale reveals that it has not depreciated. At the start of 1957 the *Feuer* had an adjusted basis of $326,627.73. In December of 1957 it was sold for $695,500. The Commissioner claims Congress never intended to permit further depreciation under such circumstances, and that a depreciation deduction claimed when the taxpayer knows with certainty that the asset has appreciated rather than depreciated must be disallowed as unreasonable. The Commissioner does not seek to recapture the depreciation deductions allowed for 1955 and 1956. He is content with contending only that depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis.

Though perhaps logically inconsistent, this position is strongly suggested by the opinion of the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (1958), which first permitted the Commissioner to disallow depreciation deductions on assets sold for more than their adjusted basis. In 1941-42 the taxpayers in *Cohn* began to operate three flying schools to train pilots under the Army Air Corps Contract Flying School Program. The taxpayers determined that their contracts for operation of the schools would terminate at the end of 1944, and the equipment they had purchased to operate the schools should be depreciated over a useful economic life ending on December 31, 1944. In computing their depreciation deductions, the taxpayers neglected to place any salvage value on the

equipment, though operators of similar flying schools used an estimated salvage value of ten percent in establishing their depreciation schedules. One of the schools ceased its operations on August 4, 1944, and its equipment was sold at auction during that month. The property of the other two schools was auctioned off in November of 1944. Because of wartime shortages, the equipment brought substantial sums, exceeding the adjusted basis of the assets at the beginning of 1944. The Commissioner disallowed the depreciation deductions for all the years as excessive and unreasonable. The District Court found that a salvage value of 10% of the original cost should have been used in computing the depreciation schedules and that the actual sales price should have been substituted for the salvage value in the year in which the asset was sold. Only the latter holding was appealed to the Sixth Circuit, which affirmed the District Court.

The holding of *Cohn* has been variously construed. Some have taken a very narrow view, reading *Cohn* as holding only that on the peculiar facts the District Court's finding that the salvage value should be redetermined in the year of the assets' sale to reflect the sales price was not clearly erroneous. Others have considered it to lay down a rule of law that the depreciation deduction for the year in which an asset is sold must be adjusted to limit the deduction to the amount, if any, by which the adjusted basis at the start of the year exceeds the sales price. Compare *Motorlease Corp.* v. *Comm.,* 215 F. Supp. 356, 361-64 (D. C. Conn. 1963) (rev'd on appeal, July , 1964) and Note, 41 Ore. L. Rev. 159, 165-66 (1962) with *Randolph D. Rouse,* 39 T. C. 70 (1962); Rev. Rul. 62-92, 1962-1 C. B. 29; and Note, 37 Tex. L. Rev. 787 (1959).

Though it could have been more explicit, we think that the *Cohn* case adequately supports the Commissioner's position and supports affirmance of the Tax Court's decision in this case. Section 167(a) of the Internal Revenue Code states as a general rule: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business . . ." Thus the dispute centers about whether it is reasonable to allow a deduction for depreciation in the year in which an asset is sold for more than its adjusted basis. We think such an allowance unreasonable, for it contravenes the basic purpose of the depreciation deduction.

Basically, our income tax is a tax on net income, and the expenses of generating income are normally considered deductible from gross income. The purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging the diminution in the asset's value each year against the gross income of that year. Because our income tax system is based on annual reporting and liability and the taxpayer normally holds wasting assets for more than a year, the proper amount of depreciation to be taken each year must depend on estimates. The proper depreciation allowance "is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the property, equal the cost . . . of the property . . ." Treasury Regulations, § 1.167(a)-1. See also *United States* v. *Ludey,* 274 U. S. 295, 300-301 (1927).

The Commissioner does not claim that the depreciation schedule adopted by the taxpayer in 1955 when the *Feuer* was purchased was unreasonable. Rather his claim is that it is unreasonable to follow an estimate when one knows that estimate is incorrect. The Commissioner's position finds support in § 1.167(b)-0 (a) of the Regulations in force during 1957:

> "Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made."

We think the Regulations make it plain that the relevant time for assessing the reasonableness of the depreciation deduction is the end of the period for which the return is made. At the end of 1957 it hardly seems reasonable to claim that the value of the *Feuer* had declined below its adjusted basis.

To be sure, the Regulations also provide that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value." § 1.167(a)-1. If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods. But no such practical difficulty presents itself here. All that is required

is a comparison of the asset's selling price with its adjusted basis. A sale which indicates that an estimated decline in an asset's value is greatly out of line is not a "mere fluctuation in market value," but "a single and final adjustment in the closing of the books on the asset involved." *Cohn* v. *United States, supra,* 259 F. 2d at 378.

Though the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain, the depreciation allowance is measured by the net cost of the asset to the taxpayer. If an asset costs a taxpayer nothing for a year, the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance. Here the sale established with mathematical certainty that the entire cost of the ship had been recovered by the sale. No injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it.

Little support for the taxpayer's position can be derived from Congressional passage in 1962 of § 1245 of the Internal Revenue Code. Section 1245 is addressed to a much broader problem than disallowance of depreciation deductions for the year of an asset's sale. The *Cohn* case refused to permit the Commissioner to recapture depreciation in years other than that of an asset's sale. Section 1245 permits recapture of depreciation allowed in years prior to an asset's sale by treating gain on the transfer of certain specified property to the extent of depreciation taken after 1961 as ordinary income instead of capital gains. See generally, Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code,* 72 Yale L. J. 1483 (1963).

The judgment of the Tax Court is affirmed.

MOORE, *Circuit Judge* (dissenting):

By its decision in this case and in *United States* v. *The Motorlease Corporation,* decided this day, this court not only enacts judicial legislation which the Congress itself has rejected but overturns judicial and administrative precedents of many years' standing in the field of allowable depreciation.

The law in effect in 1957, the applicable year here, provided as to "DEPRECIATION" that "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business, or (2) of property held for the production of income. "(Sec. 167, Int. Rev. Code of 1954.) The basis, "for the purpose of determining the gain on the sale or other disposition of such property," was to be the "adjusted basis provided in section 1011." Sec. 167(f).

The Regulations provide for the setting aside as a depreciation deduction an amount "in accordance with a reasonably consistent plan," "so that the aggregate of the amounts set aside, plus the salvage value, will at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1."

"Useful life," here determined by the Commissioner to have been three years, was subject to modification "by reason of conditions known to exist at the end of the taxable year" and could be "redetermined" but "only when the change in the useful life is significant." § 1.167(b).

The other important factor, "salvage value," is defined with clarity as "the amount (determined at the time of acquisition) which is estimated will be realized upon sale

or other disposition—" § 1.167(c)-1. The Regulation contains the injunctions that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels," and that "Salvage value must be taken into account in determining the depreciation deduction . . ." The time period during which depreciation is allowable is from the time "when the asset is placed in service" until it "is retired from service." Proportionate parts of one year's depreciation are allowable for the first and last years during which the asset is in service. § 1.167(g)-10.

These underlying and controlling legal principles are clear. Their application to the facts of this case are (or should be) equally clear.

The asset or property is the S.S. Feuer. Its acquisition date was December 21, 1955—the price $469,000.

The Commissioner accepted "Useful life" as three years and salvage value as $54,000. The "reasonably consistent plan" required the setting aside of $378.65 a day for depreciation. If this were done, the "aggregate of the amounts set aside" ($415,000) "plus the salvage value" ($54,000) would equal the cost ($469,000).

During 1957 the S.S. Feuer earned some $289,340 as gross profit. To achieve this profit the Feuer had to be used and after each day of its use it had suffered wear and tear (depreciation) to the extent of $378.65. The $289,340 was not the net income on which the petitioner under the law was required to pay taxes. Its obligation rested upon net income and net income was obtained only after depreciation ($135,367.24) was deducted. Thus far there can be no variance in thought or legal result—even by the Commissioner, the Tax Court or the majority.

But just as our much vaunted system of law on a national basis can be so easily ignored and repudiated both by judical and extra-judicial fiats, even more so is this true on an international basis. International law and contract to the contrary, the Suez Canal was closed to shipping in the latter part of 1956. Suddenly the price of ships soared, petitioner chose to forego the balance (approximately one and a half years—or one-half of the agreed-upon useful life) of the contemplated three-year reasonable plan period and sold the Feuer in June 1957 for $700,000 (actually $695,500 on closing).

The tax computation should have been simple. The cost ($469,000) less depreciation to the date of sale ($277,-739.51) enabled petitioner because of its sale for $695,500 to obtain a capital gain of $504,239.51, which petitioner reported.

Particularly important is it to note that although the Suez crisis had radically affected the shipping situation and ship values, the Commissioner did not avail himself of the remedy of modification of useful life and after such redetermination then, but only then, of a redetermination of salvage value. Actually his own regulation prevented him from changing salvage value "merely because of changes in price levels."

Faced with this insurmountable barrier of Congressional enactment, precedent, and regulation, the Commissioner resolved the problem by the simple and much-used device of amending the statutes without the aid or even participation of Congress. To the depreciation allowance section he merely added in substance the words "except in the event that the asset shall be sold prior to the expiration of its useful life, in which event no depreciation shall be

allowed for the year in which such sale is made if the price realized exceeds the depreciated cost at the beginning of such taxable year."

There would have been nothing wrong with such a statute; in fact, the Treasury had been trying to have similar provisions enacted for years. If, however, under our three branches of government system, the legislative branch does not function to the satisfaction of the executive and judicial branches, it is apparently incumbent on the latter two to take over the legislative powers. To be sure the taxpayer had planned his business transaction relying on the law as it was on the books at the time but sooner or later taxpayers must learn not to rely upon Commissioner's rulings, acquiescences, prior audits—or even Commissioners and courts.

What possible rationale is available for the result reached by the majority? They first infer that the Commissioner is being quite magnanimous in being "content" with only a 1957 disallowance as if taxes and the law were to depend on Commissioners' whims, caprices and contentment. They recognize that in so doing that the Commissioner was "perhaps logically inconsistent" as indeed he was. In enacting his own *ex post facto* legislation, he might just as well have had a sale for more than cost eliminate all depreciation for three years or even from the date of acquisition.

To arrive at its result the majority relies exclusively on what it can only call a strong suggestion in *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958). It ignores (as it must) the many Supreme Court decisions and the statutes and regulations leading to a contrary result. When the *Cohn* case is read, no principle is found therein

which could support the Commissioner's ruling. The taxpayers in *Cohn* had not fixed any salvage value for their property at the end of its useful life. For this value the District Court chose the sale price. There was no holding in *Cohn* that sale price during the course of useful life (here at the half-way point) should eliminate all depreciation in the year of sale. Nor can *Cohn* possibly be stretched to stand for the proposition that any "reasonably consistent plan" adopted by a taxpayer is to be considered as abrogated by a sale. Any such conclusion would be in specific disregard of the statutes and regulations which provide for the methods of redetermination of useful life and salvage value.

In *Randolph D. Rouse,* 39 T.C. 70 (1962) (the Tax Court here held it "necessary to recognize the *Rouse* case as dispositive of the question presented in this case") relied upon *Cohn.* Depreciation was disallowed only as to the houses which Rouse had sold. Since he had not adopted any "reasonably consistent plan" or estimated any salvage value at the time of acquisition a situation somewhat similar to that in *Cohn* existed. Neither set of facts leads to a result which should be controlling or even persuasive here.

The Tax Court assumed, erroneously and without any supporting basis in my opinion, that "changes in economic conditions have brought about new considerations by the courts of the old, well-established rules relating to depreciation allowances in the light of the rising market prices of used assets and the corresponding realization of large gains upon the resale of such used assets." *Massey Motors, Inc.* v. *United States,* 364 U.S. 92 (1960) and *Hertz Corp.* v. *United States,* 364 U.S. 122 (1960) are

cited as examples for this proposition. Actually neither case justifies any such conclusion. Both cases involved taxpayers whose business experience enabled them to determine an estimated salvage value based upon sales long before the end of the physical life of the automobiles used in their businesses. Instead of declaring the principle that sale automatically disqualified a taxpayer from claiming depreciation if the sale price was higher than the depreciated value at the beginning of the year, the *Massey* case, as to one of the taxpayers, used the estimated salvage value of $1,325 per car instead of the actual sales price of $1,380. Had the Supreme Court wished to declare the principle now urged by the Commissioner, it had every opportunity to do so merely by taking the actual sales price. However, it did not.

A thorough and well reasoned analysis of the depreciation problem is set forth in the trial court's decision in *The Motorlease Corporation* v. *United States of America,* 215 F. Supp. 356 (D. Conn. 1963). Although a panel of this court "On the authority of, and for the reasons given in *Fribourg Navigation Co.* v. *Commissioner,* 2d Cir., Docket No. 28165, decided today," reversed *Motorlease,* this case in reality supplies neither reasons nor authority. *Motorlease* reaches its result by saying "neither the Code nor the regulations are dispositive of the issue." To ignore the tax law as clearly written and the interpreting regulations is quite essential to a decision in contravention of such laws. This court in *Motorlease* does not believe that the transmutation of ordinary income into capital gains should be encouraged. Here is another example of the judicial enactment of a law which Congress itself over a long period of years had rejected. As pointed out in *Evans* v. *Commissioner,* 264 F. 2d 502, 513 (9th Cir. 1959),

rev'd on another ground sub nom. Massey Motors, Inc. v. *United States,* 364 U. S. 92 (1960), "The legislative history of section 117(j) shows that Congress had not receded from its original purpose. Congress was aware of the Commissioner's contention that taxpayers were converting into capital gains ordinary income arising from unreasonable deductions for depreciation." After reviewing various legislative attempts to have gain treated uniformly as ordinary income the court added tersely, "The recommendation was heard but not adopted." 264 F. 2d at 514.

In *Motorlease* the Commissioner did what he did not do in *Massey.* He took sale price as a new and substituted salvage value despite the specific requirement that it was to be "determined at the time of acquisition." Thus *Motorlease* as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in *Massey* and *Evans.*

The factual distinction which makes *Fribourg,* even as the majority decide it, completely inapplicable to *Motorlease,* is that *Fribourg* admittedly does not deal with a business which consisted of short time use of property and its sale before the expiration of its physical life. *Motorlease* was analogous to, and should have been controlled by, *Massey, Evans* and *Hertz.* Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein.

Another series of illuminating beacons the light of which is more than adequate to reveal the right path are recent district court cases from other circuits.

In *Wyoming Builders, Inc.* v. *United States,* decided March 25, 1964, U. S. D. C. D. Wyo., the court was confronted with a refund case involving the disallowance of

depreciation on property sold two months before the close of the taxpayer's fiscal year (November 1, 1957—October 31, 1958). The property, an Air Force base housing project, had been set up on a seventy-five year lease basis, all improvements to remain the property of the government upon expiration or termination. When the property was sold to the government in 1958, the taxpayer, as here, reported as a capital gain the difference between the sale price and the cost less eight years' depreciation. The court considered the applicable statutes and regulations as well as the *Cohn* case and concluded that the government's theory that no depreciation occurred in the year of sale was untenable, saying in part:

> "Depreciation occurs by use; the use of the property by the taxpayer until September 1, 1958, when the sale took place, resulted in a continued depreciation of the property until September 1, 1958. The expense of using the property was properly allocated by the taxpayer to the period of time which was benefited by that asset, that is, from the beginning of the fiscal year in issue until the date of the sale. Depreciation is the measure of the cost of that part of the assets which has been used up or gradually 'sold' through wear and tear." *United States* v. *Ludey,* 274 U. S. 295, 301 (1927).

The conclusions of the court in *Wyoming Builders* are so consonant with the law that it is impossible to conjure up countervailing arguments. The court held that "Neither the law nor the regulations permit this court to substitute the term 'sale price' for the regulation's term 'reasonable salvage value,'" and that "to sustain the disallowance of taxpayer's depreciation deduction would require an un-

warranted judicial extension of the Code and Treasury Regulations." The court believed, as do I, that, if the law is to be changed, "Congress, not the Court, must enact adequate controls and set the standards."

The history of the *Wier Long Leaf Lumber Co.* case, 9 T. C. 990 (1947) and the Commissioner's acquiescence (1948-1962), his non-acquiescence (1962) and its affirmance and partial reversal on other issues, 173 F. 2d 549 (5th Cir. 1949), is relevant here. The Tax Court held that the sale of depreciated automobiles did not preclude any depreciation allowance in the year of sale and that "mere appreciation in value due to extraneous causes [here the Suez situation] has no influence on the depreciation allowance, one way or the other."

Kimball Gas Products Co. v. *United States,* 63-2 U. S. T. C. ¶ 9507, W. D. Tex. 1962 was brought for a refund for overpayment of taxes due to the Commissioner's disallowance of depreciation in the year of sale (1959) of properties acquired in 1955 which for depreciation purposes had useful lives of seven years. The Commissioner disallowed one-half of the depreciation claimed in the year of sale. The court held that the taxpayer was entitled to the full depreciation and a tax refund.

The taxpayer in *S & A Company* v. *United States,* 218 F. Supp. 677 (D. Minn., 1963), a company manufacturing and selling outboard motors, sold its land and depreciable assets on April 1, 1956 to a company which continued the business. It claimed deduction for depreciation from September 1, 1955 to April 1, 1956 in its 1955-1956 fiscal year. The issue framed there was identical with the issue here. The court reviewed in detail the history of the tax laws material to the subject, the Regulations, the *Massey, Hertz, Cohn* and *Wier Long Leaf Lumber* cases and came

to the conclusion that the Commissioner improperly disallowed the deduction. In the course of its opinion the court pointed out the distinguishing features of the *Cohn* case (assuming it to be correct), namely, that although "a sale of an asset at the end of its useful life for an amount in excess of its undepreciated cost at the beginning of the year will justify a redetermination of salvage value," it is equally clear that the Tax Court held that sale of assets prior to the end of "useful life" at a price in excess of undepreciated cost at the beginning of the year of sale does not justify a determination of salvage value because the excess of price over cost is mere appreciation in value.

Refutation cannot be found in saying that these are only district court decisions. They are decisions which apply the tax statutes as they were written and the Supreme Court cases for the principles expounded therein. They do not attempt to ascribe to Congress an intent not enacted into law. Rather the legislative history has disclosed that Congress had been aware of the problem and had intentionally chosen not to act.

The fallibility of the majority opinion is that it completely ignores that law. The majority say "Because our income tax system is based on annual reporting . . . the proper amount of depreciation to be taken each year must depend on estimates." They should have taken notice of the statutory words requiring that salvage value be "determined at the time of acquisition"—of necessity, an estimate. They then interpret the Commissioner's claim to be that it is "unreasonable to follow an estimate when one knows that estimate is incorrect." To impute such a claim to the Commissioner is to imply that he is unable to read, understand and follow the specific provisions of the law

under which he can always seek to rectify an incorrect estimate. Instead of pursuing such a remedy here, the Commissioner concedes the accuracy both of useful life and the salvage value "determined at the time of acquisition."

Finding no support in law for its position and forced to concede that "the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain," the majority satisfy themselves with the belief that "no injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it." Any such legal philosophy has the effect of writing depreciation allowances and depreciation as a matter of sound accounting out of the tax laws. Possibly they intend by their opinion to do so because under such circumstances they say "the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance." This approach can scarcely be reconciled with their comment that, "If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods." It was for this very reason that the Regulation, § 1.167(c), provided that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels." Of course, sales price can easily be compared with the depreciated cost at the beginning of the year. But there is no law or regulation which declares that in such event no depreciation shall be allowed if the sales price is higher. Therefore, because this decision seems to be completely at variance with the statutes and the applicable decisions, I must dissent.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the fifteenth day of July, one thousand nine hundred and sixty-four.

Present:

HON. THOMAS W. SWAN,
HON. LEONARD P. MOORE,
HON. J. JOSEPH SMITH, *Circuit Judges*

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

Order of the Court of Appeals Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twentieth day of August, one thousand nine hundred and sixty-four.

Present:

HON. THOMAS W. SWAN,
HON. LEONARD P. MOORE,
HON. J. JOSEPH SMITH, *Circuit Judges.*

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

A petition for a rehearing together with a motion for for a stay of the issuance of mandate pending application for a writ of certiorari to the Supreme Court of the United States having been filed herein by counsel for petitioner,

Upon consideration thereof, it is

Ordered that said petition for a rehearing be and hereby is denied.

Further ordered that the motion to stay issuance of the mandate be and it hereby is granted subject to the provisions of Rule 28(c) of the rules of this court.

A. DANIEL FUSARO
Clerk

APPENDIX B

Treasury Regulations*

§ 1.167(a)-1 Depreciation In General.—(a) *Reasonable allowance.*— Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic

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*As in effect during the calendar year 1957.

changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167 (d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which

an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve. [T. D. 6182, 6-11-56. Later amended by T. D. 6507, 12-1-60 and by T. D. 6712, 3-23-64.]

§ 1.167(a)-9 Obsolescence.—The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence

is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supercession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1. [T. D. 6182, 6-11-56. Later amended by T. D. 6445, 1-15-60.]

§ 1.167(a)-10 When Depreciation Deduction Is Allowable.—(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been

claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. . . . [T. D. 6182, 6-11-56.]